

# 5.01 Foreign Currency Transactions, Receivables & Payables

## Overview of Foreign Currency Matters

There are several ways in which an entity may be involved in foreign operations (ASC 830):

- They may enter into **foreign currency transactions** with an entity in a foreign country that involves a receipt or payment in a foreign currency. The entity must determine how that transaction will be reported in U.S. dollars.
- An entity may have **financial instruments denominated in a foreign currency** (eg, a *receivable or payable*), meaning it will be settled by the receipt or payment of some amount of foreign currency. The amount of the receivable or payable must be converted into U.S. dollars for inclusion on the reporting entity's financial statements (F/S).
- An entity may get involved in **foreign currency exchange transactions**, such as forward exchange contracts. These transactions may be entered into for a variety of reasons but, regardless, often result in a net amount being paid or received to settle the contract, representing a liability or asset.
- An entity may have a **foreign investee** (ie, a *foreign division or subsidiary*) that maintains books and records in a foreign currency but will be included in the reporting entity's consolidated F/S. The F/S must be converted into U.S. dollars to include them.

## Foreign Currency Transactions

When an entity enters into a transaction that will be settled through the payment or receipt of foreign currency, it is initially recognized in the **functional currency** of the entity using the exchange rate in effect on the *date of the transaction*. The exchange rate that is effective on a particular date is referred to as a **spot rate**.

An entity's functional currency is the currency that has the greatest economic impact on the entity's financial performance. A company based in the northern part of Washington, for example, may obtain all of its raw materials from Canadian suppliers, may assemble its product in the United States, and then sells all of its output to Canadian customers. Even though the company might maintain its books and records in U.S. dollars, its functional currency would be the Canadian dollar.

Various factors will be considered when identifying the functional currency. Some may be more important than others, depending on the circumstances and not all will necessarily apply.

These factors may include, for example, which currency may have the greatest influence on:

- Cash flows
- Sales prices
- Demand for the company's products or services
- Expense
- Financing and financing costs
- Intra-entity arrangements

In general, an entity's functional currency is its local currency. Usually, it is also the currency in which it maintains its books and records, but that is not always the case.

- When a transaction occurs in some currency other than the functional currency, it is **remeasured** as if the transaction had originally occurred at the functional currency.
- When the functional currency is not the same as the currency used for reporting, amounts are **translated** from the functional currency into the reporting currency.

**Transactional Currency** = Local currency (Usually the currency in which books and records are kept)

**Functional Currency** = Greatest economic impact on company (Currency in which entity generates and expends cash)

**Reporting Currency** = Currency in which the entity prepares its F/S



For example, a company's functional currency, the U.S. dollar, is also its reporting currency. On December 15 of the current year, the company enters into a transaction in which it purchases a printing press from X Company in Heidelberg, Germany at a cost of €250,000 at the time when the exchange rate was 1.30 (€1.00 = \$1.30). The balance is due on January 15 of the following year.

The transaction would be remeasured into U.S. dollars by determining the U.S. dollar equivalent of €250,000, which is  $(€250,000 \times 1.30) \$325,000$  and the transaction would be recorded as follows:

Equipment	325,000
Due to X Company	325,000

## Financial Instruments Denominated in a Foreign Currency

When an entity has financial instruments, such as accounts receivable or payable, or notes and loans receivable or payable, that are denominated in a foreign currency, they are adjusted for changes in exchange rates as of each balance sheet date.

- The carrying value of the financial instrument will be remeasured based on the *spot rate* on the balance sheet date.
- Any increase or decrease is generally recognized in *income or loss* as a foreign currency transaction gain or loss.

For example, when the company prepares its financial statements as of December 31, the exchange rate has increased to 1.35. It will now require  $(€250,000 \times 1.35) \$337,500$  to settle the obligation. The liability will be increased to that amount as of the balance sheet date and a loss will be recognized.

Foreign currency exchange loss	12,500
Due to X Company	12,500

*Note that the loss can also be calculated by multiplying the amount of the payable in Euros by the change in the exchange rate ( $€250,000 \times .05 = \$12,500$ ).*

When the instrument is settled, an additional gain or loss may be recognized if the exchange rate has changed since the last balance sheet date. When it is settled, the entity will pay or receive some amount of money and will either convert dollars into a foreign currency to make a payment or receive a foreign currency and convert it into dollars to deposit it into its U.S. bank account.

For example, when the company remits payment on January 15 of the following period, the exchange rate has decreased to 1.20. It will now only require  $(€250,000 \times 1.20) \$300,000$  to settle the obligation. The entity will buy 250,000 Euros for \$300,000 and repay the liability, resulting in the recognition of a gain.

Due to X Company	337,500
Foreign currency exchange gain	37,500
Cash	300,000